

Accounting & Risk Management in Islamic Finance

Dr. Syed Alwi

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Agenda

- Introduction
- Accounting Issues in Islamic Finance
- Risk Management in Islamic Finance
- Quiz
- Key Takeaways and Conclusion

Learning Outcomes

At the end of this session, the participants will be able to:

- Identify the distinct roles and responsibilities of the key international regulatory and standard-setting bodies within the Islamic financial system
- Assess the issues relating to “time value of money” and “substance over form” in Islamic finance
- Explain the key challenges in applying international accounting standards to Islamic finance products and transactions.
- Identify unique risks facing Islamic finance and how derivatives are structured in Islamic finance as a risk mitigation solution

Dr. Syed Alwi

- More than 25 years of banking experience
- Senior leadership experience in banking across ASEAN
- Former Managing Director of BNP Paribas (Najmah) and President/CEO of Agrobank Malaysia
- Established the corporate banking department of the first Islamic bank in Singapore – The Islamic Bank of Asia Ltd.
- Graduate from IIUM with Bachelors of Accounting and MBA (Islamic Banking)
- PhD (Finance) from Universiti Malaya, Malaysia

The Five Pillars of the Islamic Financial Services Industry

To prevent market fragmentation and ensure systemic stability, the Islamic Financial Services Industry (IFSI) relies on a specialized, non-overlapping network of **standard-setting, regulatory, and market-facilitation bodies**.



The Governance Core: Establishing Rules and Ensuring Stability



AAOIFI (The Rulemaker)

Mandate

Driving the harmonization of Islamic finance practices through the development of accounting, auditing and Shariah standards for the global Islamic finance industry.

Focus Areas

Shari'ah rulings, Accounting, Auditing, Governance, and Ethics.

Impact Metric

115 active standards and technical pronouncements (including 59 Shari'ah and 32 Accounting standards) utilized globally.



IFSB (The Stabilizer)

Mandate

Ensuring the soundness and systemic stability of the IFSI while protecting consumers and stakeholders.

Focus Areas

Prudential regulation and supervisory practices across Islamic Banking, Takaful, and Capital Markets.

Impact Metric

34 published standards, guiding principles, and technical notes tailored for regulatory assessment.

The Market Engines: Facilitating Trade and Unlocking Liquidity



IIFM (The Market Facilitator)

Mandate

Standardizing Islamic Capital & Money Market products to reduce legal documentation costs, shorten negotiation times, and create legal certainty.

Core Output

Globally standardized Shari'ah-compliant Financial Documentation (e.g., the ISDA/IIFM Tahawwut Hedging Master Agreement) and Product Confirmations.



IILM (The Liquidity Provider)

Mandate

A multilateral organization established by central banks dedicated to providing innovative tools for evolving cross-border Islamic liquidity management needs.

Core Output

Issuance of highly rated US Dollar Shari'ah-compliant financial instruments, specifically Sukuk based on Wakala structures, for medium to long-term funding.

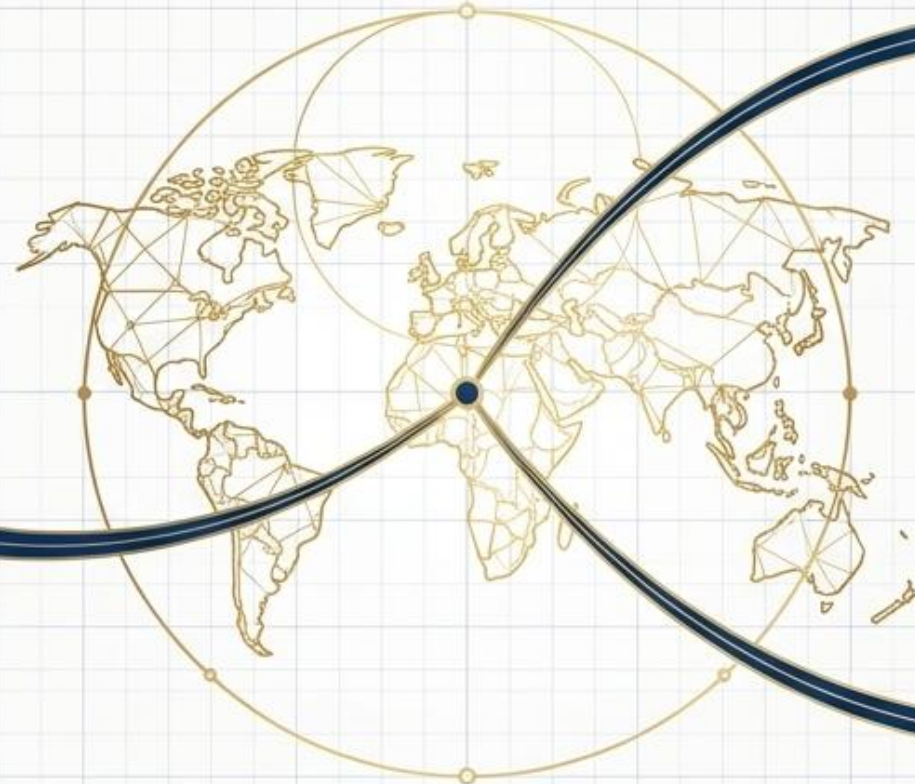
The Global Voice: CIBAFI

Archetype: The Advocate

Global Representation



The General Council for Islamic Banks and Financial Institutions serves as the definitive global advocate for the IFSI.



Deepening Objectives



Dedicated to embedding and deepening Shari'ah objectives within financial dealings and transactions.

Capacity Building



Fostering industry awareness, sharing knowledge, and facilitating direct cooperation among member institutions of common interest.

Diagnostic Matrix: The Islamic Finance Architecture

Institution	Primary Mandate	Core Mechanism/Output	HQ & Establishment
AAOIFI	Shari'ah & Accounting Harmonization	115 Standards & Pronouncements	Manama, Bahrain (1991) 
IFSB	Prudential Regulation & Stability	34 Regulatory & Supervisory Standards	Kuala Lumpur, Malaysia (2002) 
IIFM	Legal & Trading Standardization	Master Agreements & Documentation	Manama, Bahrain (2002) 
IILM	Cross-Border Liquidity	US Dollar Wakala Sukuk Issuances	Kuala Lumpur, Malaysia (Multilateral) 
CIBAFI	Industry Representation	Global Advocacy & Capacity Building	Manama, Bahrain (2001) 

The Ultimate Objective: Real-Economy Impact

The proliferation of these standard-setting bodies is not merely administrative. It is a highly intentional strategy designed to strengthen the linkage between financial services and sustainable economic development.



Introduction to Accounting issues in Islamic finance

Accounting is a process. A process to record transactions or economic events, and then recognise, measure and report the events within certain parameters to certain stakeholders to allow the decision making process to happen.

As Islamic financial institutions have peculiar features such as trading based contracts, profit sharing contracts, promissory contracts, rebates which are used to replicate a financing effect, we have had to rethink of the recording, recognition and measurement elements of the transaction to enhance the comparability of Islamic financial transactions, while being mindful of religious sensitivities

Introduction to Accounting issues in Islamic finance (cont'd)

Two key issues related to accounting for Islamic financial transactions can generally be attributed to opposing views on two main points of contention:

- (a) the acceptability of reflecting a time value of money (TVM) in reporting an Islamic financial transaction; and
- (b) the conventional approach of recognising and measuring the economic substance of a transaction, rather than its legal form.

Example 1:

Financing using Murabaha

1. Murabaha is a cost-plus sale contract in which an Islamic financial institution purchases an asset requested by a customer and subsequently sells it to the customer at the original purchase cost plus a pre-agreed profit margin. The selling price, including the profit, is disclosed upfront and may be settled either immediately or through deferred instalment payments.
2. For example, a customer wishes to purchase a house valued at RM500,000 and makes a promise to purchase the house from the Islamic bank upon the bank owning the house. The Islamic bank purchases the house from the owner, and enters into a Murabaha sale for a consideration of RM600,000, with payment deferred over 10 years.
3. From a Murabaha point of view, the RM100,000 is a trading profit for the Islamic bank from the buy and sell of the house. However, under IAS 18, the accounting treatment may view the deferred payment arrangement as containing a financing component.
4. As a result, IAS 18 requires the fair value of the consideration (RM600,000) to be discounted using an imputed interest rate. The difference between the fair value (say, RM500,000) and the nominal value (RM600,000), is recognized as interest income.

Example 1 (cont'd):

Shariah views a Murabaha transaction as a sale that generates trading profit, whereas conventional accounting standards may treat part of that profit as financing income because payment is deferred.

This difference reflects the distinction between the **legal form** of the transaction under Shariah (a sale) and the **economic substance** recognised under IFRS (a financing arrangement).

This has been one of the reasons why accounting standards for Islamic finance have evolved, including guidance issued by **AAOIFI**, to better reflect the unique characteristics of Shariah-compliant transactions.

AAOIFI Standard on Murabaha

Profit Recognition

FAS 2 (Para 8): Profits of a credit sale which will be paid by instalments shall be recognized by either of the following:

- (a) Proportionate allocation of profits over the period of credit whereby each financial period shall carry its portion of profit irrespective of whether cash is received or not.
- (b) As and when the instalments are received.

So, does Shariah rulings on Islamic Finance recognize the concept of time value of money based on the above standard?

Time value of money

The Time Value of Money (TVM) is a fundamental financial principle which states that a sum of money available today is worth more than the same amount received in the future because it can be invested or used to generate returns over time. The TVM is the essence of the concept of interest rate that gives rise to interest-based cashflows.

So, does TVM fits into Islamic finance?

- a) Some believe that it would be inappropriate to reflect a time value of money in reporting an Islamic financial transaction, when no overt interest is charged or incurred in such transactions. Some even outright refute the concept of TVM.
- b) In contrast, others believe that although charging interest on a loan is prohibited, showing the financing effect of a transaction should be allowed as it would provide information that would benefit users.

AAOIFI Ruling on TVM (SAF 2, Para 8)

- Indeed, money does not have a time-value aside from the value of goods that are being exchanged through the use of money, in accordance with Shariah.
- Islamic banks are founded on the concept of sharing profits and losses consistent with the Islamic concept of “profit is for that who bears risk”.
- Islamic banks reject interest as a cost for the use of money.

Example 2:

Islamic Hire Purchase/Leasing using Ijarah

1. Ijarah is a contract where one party transfers the usufruct of an item to another party for a specified period, in exchange for a specified consideration.
2. Ijarah may be transacted with an arrangement to transfer the ownership of the underlying asset by or at the end of the lease term. Such arrangements are commonly known as Ijarah Muntahia Bittamleek, which means 'Ijarah ending with ownership'; or Ijarah Thumma Al-Bai', which means 'Ijarah followed by a sale'.
3. Islamic accounting standards require, in Ijarah Muntahia Bittamleek, that the lease and the transfer be accounted for as separate transactions even if the two transactions are arranged in conjunction with each other.

Example 2 (cont'd):

4. Islamic accounting standards does not recognise finance leases. For example, AAOIFI's FAS 8 Ijarah and Ijarah Muntahia Bittamleek, paragraph 22 on 'Ijarah Muntahia Bittamleek in the financial statements of the Islamic bank as a lessor' states:

*"Leased assets shall be presented in the **lessor's** statement of financial position under Ijarah Muntahia Bittamleek Assets and shall be measured at their book value."*

5. The above accounting treatment may be in conflict with IFRS 16: Leases

"A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Otherwise a lease is classified as an operating lease.

A lessor recognises assets held under a finance lease as a receivable at an amount equal to the net investment in the lease upon lease commencement."

IFRS 16: Leases

- 61. A lessor shall classify each of its leases as either an operating lease or a finance lease.
- 62. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.
- 63. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
 - (a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
 - (b) the lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised;
 - (c) the lease term is for the major part of the economic life of the underlying asset even if title is not transferred;
 - (d) at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and
 - (e) the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.

AAOIFI Standard on Ijarah

- AAOIFI FAS 8 standard requires Ijarah to be treated as an operating lease regardless of the circumstances accompanying the Ijarah arrangement.
- Conceptually, Ijarah is an operating lease because in Shariah, it is prohibited for an aqad to have more than one transaction with contradicting results (i.e combining a lease and sale). In conventional lease, it is acceptable to have a lease and sale transaction in a contract. This is prohibited in Shariah.
- Four options to transfer the title of the asset to the lessee; by way of a gift; token sale price; mutually agreed sale price or; gradual sale of a portion of the asset.
- If the asset is sold prior to the end of the term of the lease, legal title shall pass to the lessee when he buys the leased assets for a price that is equivalent to the remaining Ijarah instalments and the lessor shall recognize any gain or loss resulting from the difference between the selling price and the net book value. [AAOIFI FAS 8, paragraph 44].

Substance Over Form

- Islamic finance places significant importance on the legal and Shariah form of a transaction because contractual rights and obligations determine the ownership, risks, and responsibilities of the parties involved.
- Some believe that it is acceptable, and would benefit users more, to show the economic substance of an Islamic financial transaction, and information about the legal form may be relegated to the notes to the financial statements.
- In Islamic finance, ownership is more than an accounting concept—it carries with it rights, responsibilities, and accountability. A party is entitled to earn a return only if it has genuinely assumed the ownership risks and obligations associated with the underlying asset.

Issue on PER and Mudharabah

- In classical texts, Mudharabah is a type of partnership where one party contributes capital, and another contributes entrepreneurship towards a commercial venture.
- Profits made on the venture are shared between the partners in a pre-agreed ratio, but any losses would be borne by the capital contributor.
- In modern Islamic finance, Mudharabah has been used for deposit products. A customer may place amounts in a Mudharabah account which would be managed by the bank. Profits made through the arrangement would be shared between the accountholder and the bank.
- Losses should, theoretically, be borne solely by the accountholder. However, many banks endeavour to provide consistent returns to accountholders and/or maintain parity between Mudharabah profit sharing accounts and conventional fixed deposit accounts. The need to provide consistent returns on a profit-sharing arrangement is known in the industry as ‘displaced commercial risk’ (“DCR”).
- AAOIFI allows the profit smoothing process to be done using tools such as Profit Equalization Reserve (PER); and Investment Risk Reserve (IRR).

Issue on PER and Mudharabah (cont'd)

1. Profit equalisation reserves

In times of higher profits, some of the funds' income, representing both the IIFS and accountholders' portions, would be set aside in a reserve which would be released in times of lower profitability to give 'additional' returns to account holders.

2. Investment reserve risk

In times of higher profits, some of the accountholders' portion of profits would be set aside in a reserve which would be released in times of lower profitability to give 'additional' returns to account holders.

Issue on PER and Mudharabah (cont'd)

- a) PER represents an amalgamation of both the accountholders' and the financial institution's shares of profits. Thus, it creates a 'hidden reserve' for the bank.
- b) What would the accounting entries be to reflect the customers' portion of the PER, when it is reversed?
- c) What would be the required internal approvals and governance process to reverse the customers' portion of the PER?
- d) As Mudharabah deposits does not require the Islamic bank to guarantee profit nor principal, would it be reported as a liability in the bank's financial statement?
- e) How do Islamic banks ensure fairness and justice in utilizing PER or IRR for depositors who close their accounts?

Introduction to Risk management issues in Islamic finance

Risk management is the process by which various risk exposures are:

(1) identified, (2) measured/assessed, (3) mitigated and controlled, (4) reported and monitored.



Failure to manage risk can have adverse implications to the business and generally to society and the economy.

What is Risk?

Risk is the probability of loss of income and asset value. Only expected and unexpected losses are included in the calculation of risk, while known losses are not included in the definition of risk.

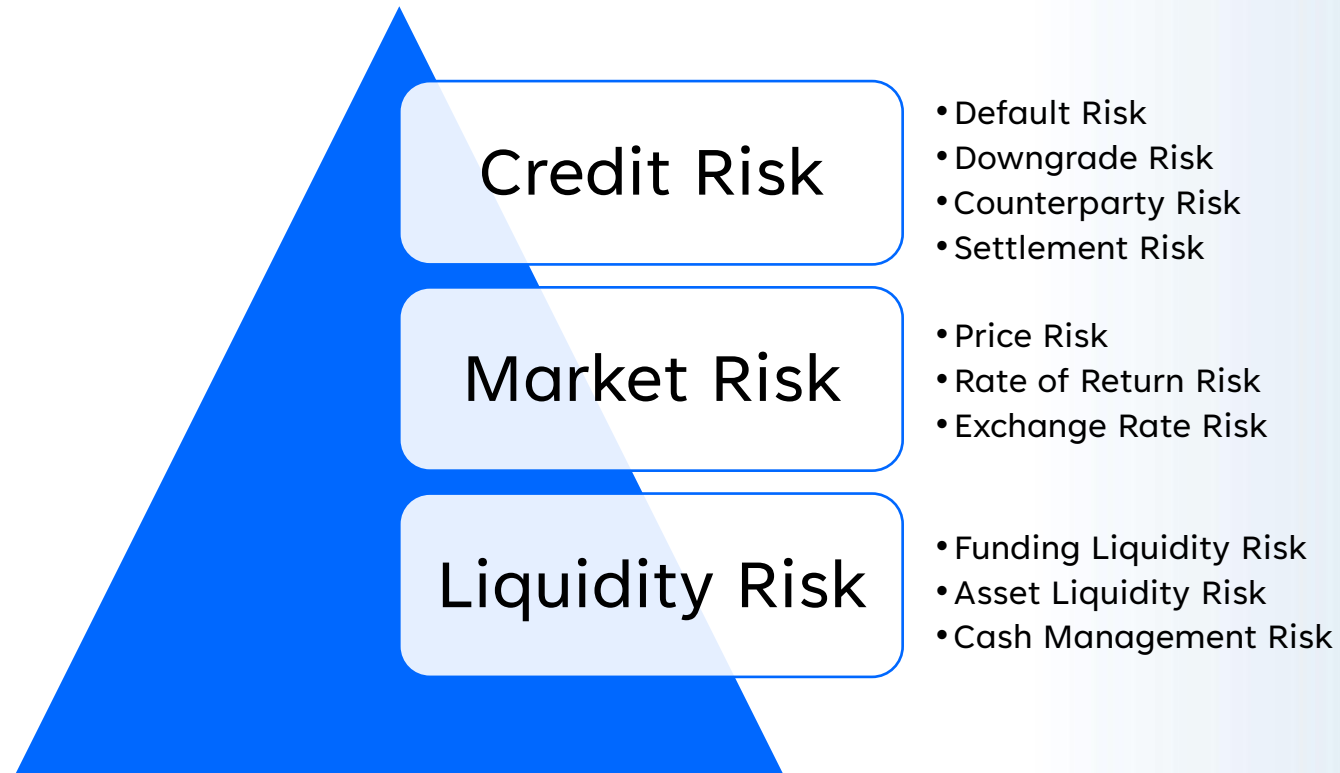
Risk and Return

- The concept of risk arises because it is related closely to profitability measurements i.e investment target, risk tolerance etc.
- The pursuit of profits, gives rise to risk-taking behaviour, which has to be managed using risk management tools and methodologies.

6 Types of Common Risks in Banking



Financial risk factors



Business risk factors

Management Risk

- Planning
- Organization
- Reporting
- Monitoring

Strategic Risk

- Research and development
- Product design
- Market dynamics
- Economic
- Reputation

Operational risk factors

- Relationship
- Ethics
- Processes Risk

People Risk

Legal Risk

- Document Control
- Compliance

- Hardware
- Software
- Models
- ICT

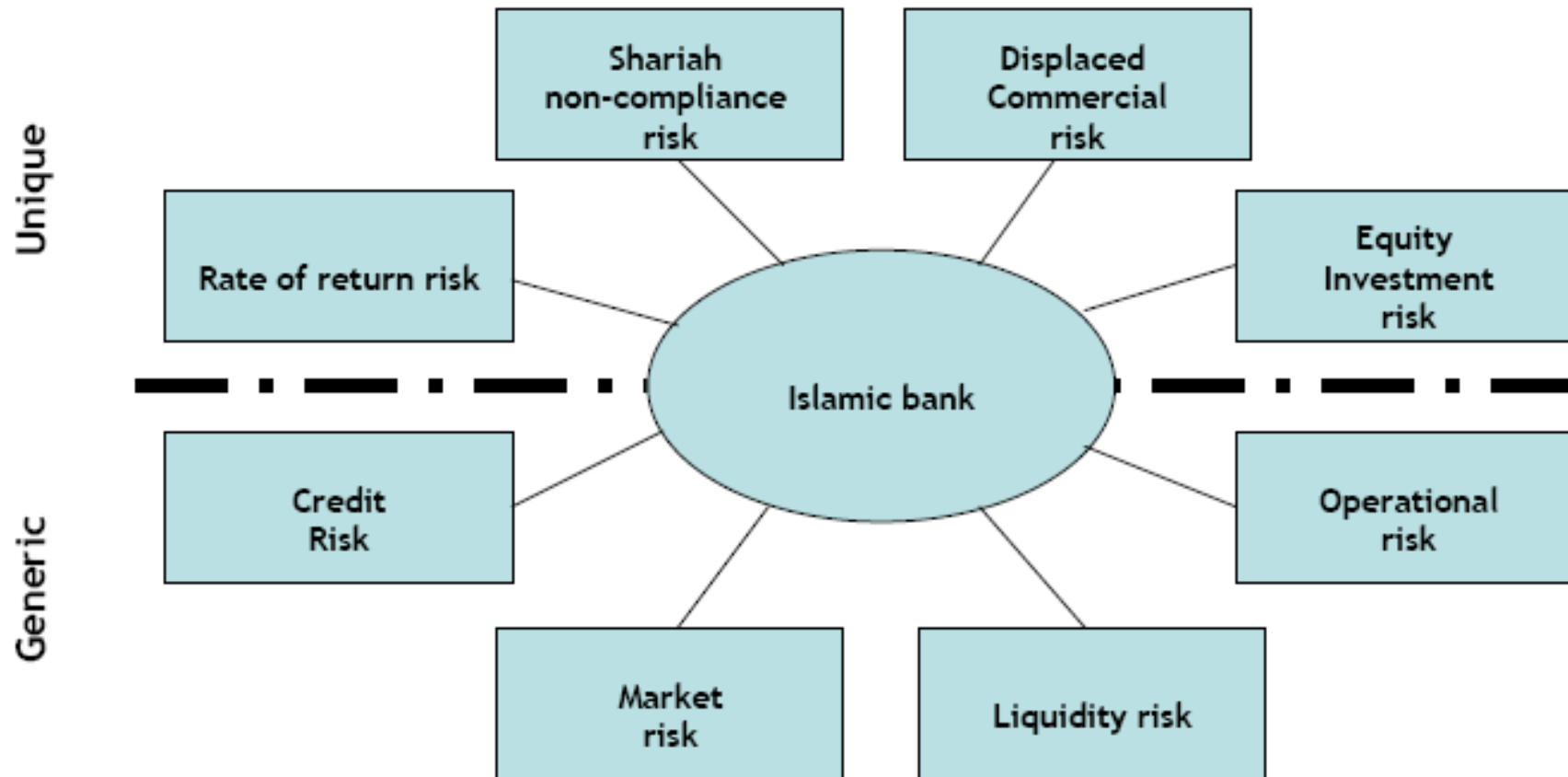
System Risk

External Risk

- Shareholders
- Regulatory/Supervisory entity
- Client
- Systems

Equity
Investment
Risk

Risk Profile of an Islamic Bank



Interest Rate/Rate of Return Risk

- Clearly, one of the most important risks in banking because, the net interest income (NII)/net profit income (NPI) is the core source of revenue.
- NII/NPI is defined as the income received from lending/financing activities or debt instruments held (for example, subordinated debt, senior debt, or certificates of deposit issued by other financial institutions) less the expense incurred on deposits or issued debt instruments.
- Net Interest Margin (NIM) or Net Profit Margin (NPM) is a key bank profitability metric, given by the gap between interest/profit income and interest/profit expense, divided by assets.

NIM/NPM of Selected Banks

	Bank	2024	2023	2022
1.	Bank Islam Malaysia Bhd	2.23	2.23	2.38
2.	Bank Muamalat Malaysia Bhd	2.06	2.10	2.52
3.	CIMB	1.86	1.81	2.09
4.	Maybank	1.72	1.78	2.14
5.	Bahrain Islamic Bank B.S.C	2.34	5.09	4.55
6.	Dubai Islamic Bank	3.05	3.28	3.28
7.	PT Bank Muamalat Indonesia	0.30	0.23	0.62
8.	PT Bank Mandiri Indonesia	5.08	5.33	5.51
9.	Bank Islam Brunei Darussalam	4.31	4.64	4.09
10.	Emirates Islamic Bank	5.13	5.65	4.14

What observations can be made of the NIM/NPM of the banks above?
Discuss.

NIM/NPM (cont'd)

- There is no “gold standard” for NIM/NPM in banks.
- Amongst factors that influence NIM/NPM:
 - Equity capital held by banks
 - Amount of credit lending/financing
 - Non-interest bearing liabilities or deposits
 - Business focus in SME vs large corporate vs retail customers
 - Amount of residential mortgage financing

Gap Risk

- Gap risk is the risk that revenue and earnings decline as a result of changes in interest rates, due to the difference in the maturity profile of assets, liabilities and off-balance-sheet instruments. Another term for gap risk is mismatch risk.
- The main derivative instruments used to manage gap risk are Forward Rate Agreements, futures and interest-rate swaps. In Islamic finance, swaps are also available such as Forwards, Profit rate swaps etc.
- Interest-rate/profit rate derivatives are more flexible than cash hedges and will be the instrument of choice of most medium/larger banks.
- Smaller banks, on the other hand, may prefer to maintain all operations in cash instruments, either for simplicity or to avoid the additional accounting (for example, potential P&L volatility if hedge accounting arrangements are not put in place) and operational challenges (for example, collateral posting for negative mark-to-market positions) posed by derivatives.

Financial Derivatives: A Shariah Analysis

Here is a standard definition of financial derivatives:

“an agreement between two parties to transact the underlying asset at a future date for an agreed upon price”.

The definition of “Financial Derivatives” has four elements; a) an agreement between two parties; b) to transact the underlying asset; c) at a future date; d) for an agreed upon price.

Agreement between two parties	• The two parties to a derivative agreement are also sometimes known as counterparties. • These parties can be a combination of an individual customer and a bank, or between two banks, or between a bank and corporate client or even between two corporations. • From a Shariah viewpoint, each of the above combination is permissible provided the client and the underlying agreement are not disqualified as non compliant to Shariah principles i.e. a casino operating business shall not enter into Islamic FX forward to hedge against the cost of purchasing a jackpot machine.
Underlying asset	• Derivative agreements can be transacted on such underlying assets such as shares of stock, interest rates, currencies and commodities such as crude oil, palm oil etc. • An Islamic derivative may be structured with similar underlying assets, provided the assets are not prohibited foodstuff or impermissible commodities according to Shariah principles.
Future Date	• Financial derivative contracts expire at a future date wherein settlement happens upon expiration. • Therefore, three potentially distinct dates are the “trade date” which is the present date when the contract is entered into, the “settlement date” and the “maturity date”. • From an Islamic viewpoint, it is disallowed to enter into a binding contract at present date with both countervalues of the contract i.e. price and underlying assets, being exchanged at a deferred date in the future.
Agreed upon price	• Price can be “forward price”, “futures price” or an “exercise price” for an option contract. • From a Shariah viewpoint, there can only be one price for each contract and it cannot be deferred to a future date if the contract is made binding at present (and where the exchanged asset is also deferred to a future date.)

Pitfalls: Derivatives vs Shariah

Non existent countervalues	• The countervalues in the two sides of the trade are both non-existent at the time of contract i.e. no good is delivered and no price is paid, though there is a binding contractual agreement between the parties. • To validate a sale from the perspective of the Shariah, it is necessary that at least one of the countervalues should be present at the time of the contract.
Prohibition of Riba	• ALM manages short term liquidity by buying Government bills such as MGS etc. These papers are interest based papers. • Interest rate swaps and cross currency swaps are based on the exchange of cashflows from interest rates of the underlying asset.
Prohibition on payment of fee for a promise	• A promise to deliver is binding on the promisor, according to both English Law and the Shariah. • However, such a promise does not justify the imposition of a fee by the promisor as a promise is not a consideration. Hence, rendering options impermissible.
Prohibition on Gharar and Maysir	• Taking a position on the underlying benchmark i.e. interest rate benchmark, commodity index, equity index etc, is akin to speculation. • Hence Islamic products structured purely on the basis of such market positions are prohibited.

Islamic Profit Rate Swap (IPRS)

What is it?

In the conventional financial world, this derivative instrument is known as Interest Rate Swaps (IRS).

An IRS is an agreement between two parties to exchange streams of cashflows of two sets of interest-based payment obligations for a period of time.

In other words, two parties come together and agree to exchange or transfer the debt payment streams of each other without transferring the underlying debt.

Why?

This is a risk management method of cost reduction strategy for debtors who have certain expectations on future movement of the market interest rate.

CASE STUDY



Islamic Profit Rate Swap (IPRS)

Example

Consider Beras Holdings – a hypothetical national paddy and rice importer – which issued a Sukuk for RM400million with a tenor of 5 years paying a fixed coupon rate semi annually of 7% per annum.

Shortly after issuance, its CFO decided that the market interest rate will continue to fall and thus swapping from a fixed payment obligation to a floating rate will provide them with possible cost savings. The following swap scenarios were provided to them:

- a) Notional Amount to hedge: RM400million
- b) BerasCorp receives at every 6 months: 7% p.a on notional amount
- c) BerasCorp pays at every 6 months: Prevailing 6 month-KLIBOR plus margin of 2%

Islamic Profit Rate Swap (cont'd)

Indicative Terms and Conditions

Notional	MYR 400 mio
Start Date	3 August 2026
Maturity	2 August 2031
Client Receives	MYR 7%, SA, Act/365
Client Pays	MYR 6mth Klibor + 2% All in rate capped at 8%

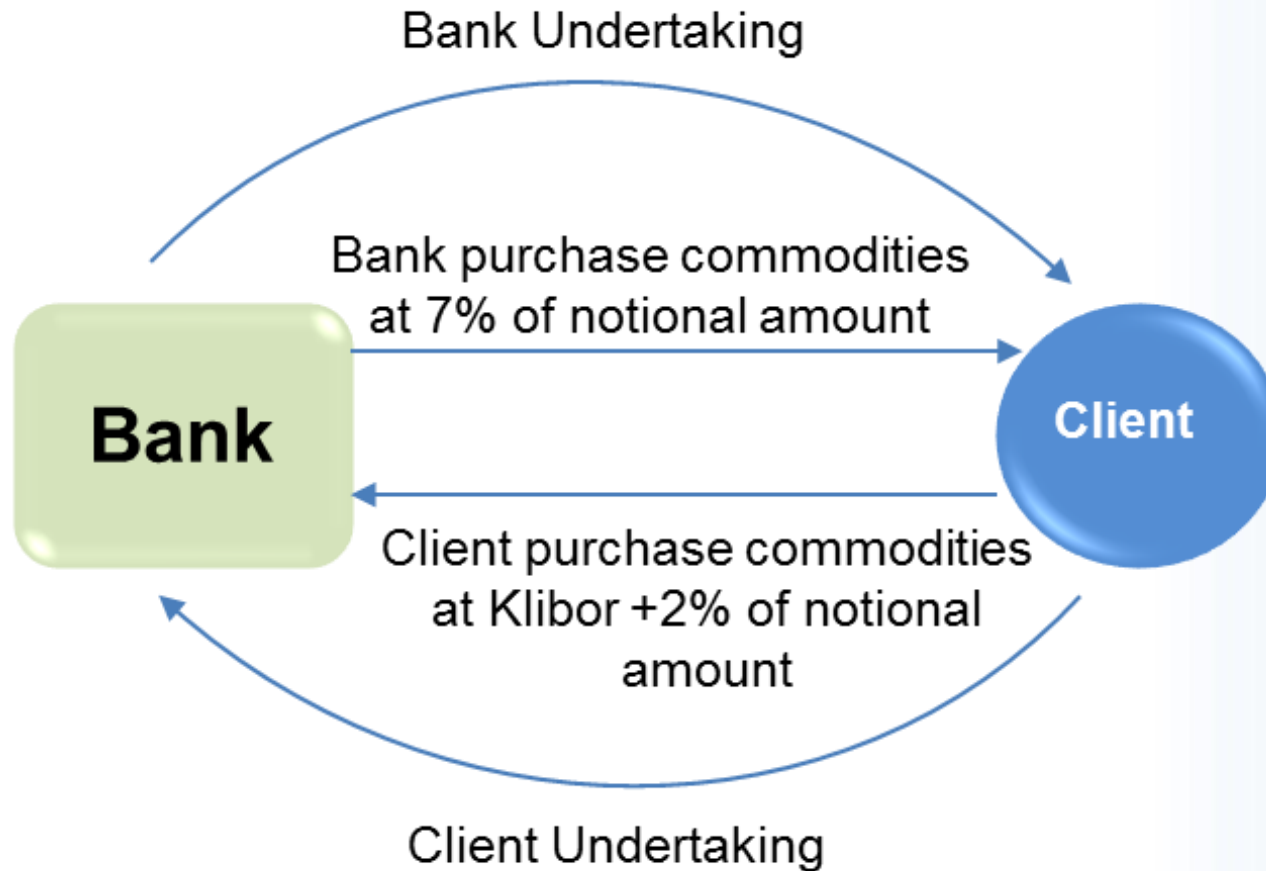
Rationale

- Client takes advantage of low interest rates environment with a view that rates will remain low
- Client enjoys initial positive carry (depending on KLIBOR)
- Client's break even rate is when 6m Klibor is at 5.00%
- Worst case is known upfront for client. "floating rate + Spread" that client pays is capped at 8%.

Scenario Analysis

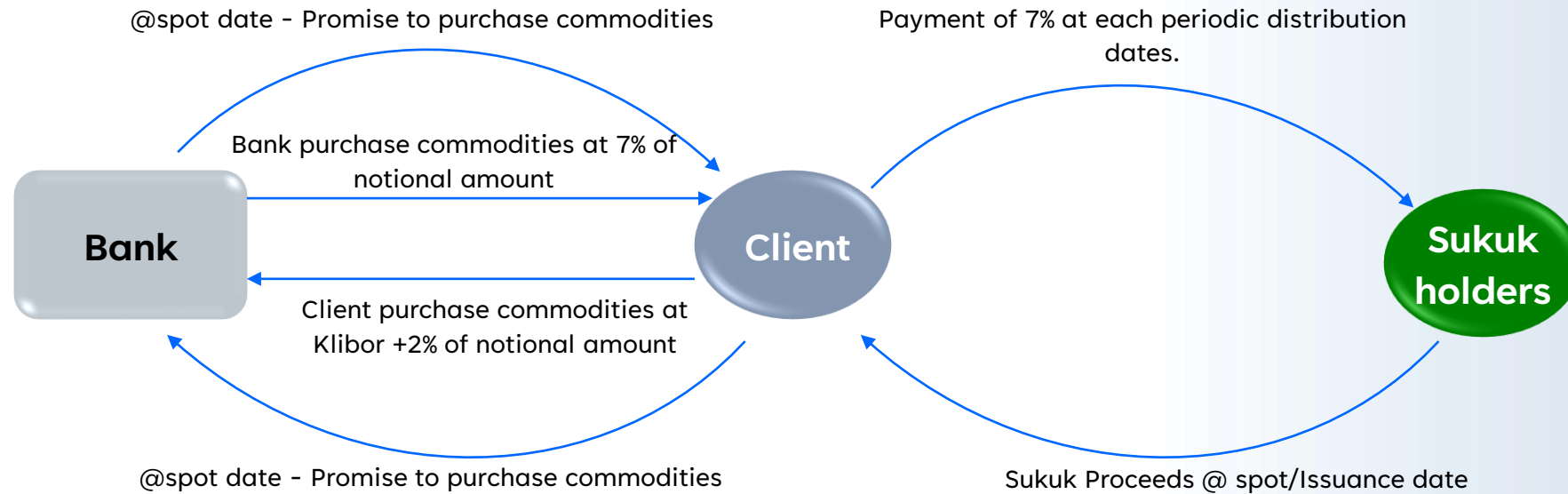
6m Klibor	Effective funding cost	Saving
3.00	5.00%	+200bps
4.00	6.00%	+100bps
5.00	7.00%	Breakeven
6.00	8.00%	-100bps
7.00	8.00%	-100bps

Islamic Profit Rate Swap (cont'd)



Islamic Profit Rate Swap (cont'd)

Wa'dan Structure with undertaking by the respective counterparties to buy commodities at the Sale Price at each Calculation Date/Trade Date



What Happens @ Spot

- Client (Beras Holdings) provides promise to purchase commodities at Sale Price given in the Exercise Notice
- Bank (counterparty) provides promise to purchase commodities at Sale Price given in the Exercise Notice

What Happens @ Calculation Dates

- Client purchases commodities from the Bank at Sale Price of Klibor + 2% of notional amount
- Bank (counterparty) purchases commodities from the Client at 7% of notional amount
- Client pays the 7% to Sukukholders

Islamic Profit Rate Swap (cont'd)

Wa'dan Structure with undertaking by the respective counterparties to buy commodities at the Sale Price at each Calculation Date/Trade Date

- Variation 1 - In some instances, the documentations will be structured to only effect ONE promise, instead of both. Therefore, only one Commodity Murabaha will be transacted at each Calculation Date.
- This will be done by way of identifying Rate 1 and Rate 2. (Assume Rate 1 is 7%, Rate 2 is Klibor + 2%)
- A condition will be stated in the Termsheet that reads as follows:
 - The Bank Undertaking is exercised only if on the relevant Calculation Date the Rate 1 is greater than or equal to the Rate 2.
 - The Customer Undertaking is exercised only if on the relevant Calculation Date the Rate 1 is less than the Rate 2.
- Variation 2 – In the above instance, the amount of profit to be paid will be a net amount, being the difference between Rate 1 and Rate 2. A formula as follows may be included in the Termsheet:
 - If Bank Undertaking is exercised:

$$\text{Notional Amount} * [(\text{First Rate} * \text{First Rate Day Count Fraction}) - (\text{Second Rate} * \text{Second Rate Day Count Fraction})]$$
 - If Customer Undertaking is exercised:

$$\text{Notional Amount} * [(\text{Second Rate} * \text{Second Rate Day Count Fraction}) - (\text{First Rate} * \text{First Rate Day Count Fraction})]$$

Case 2

Example

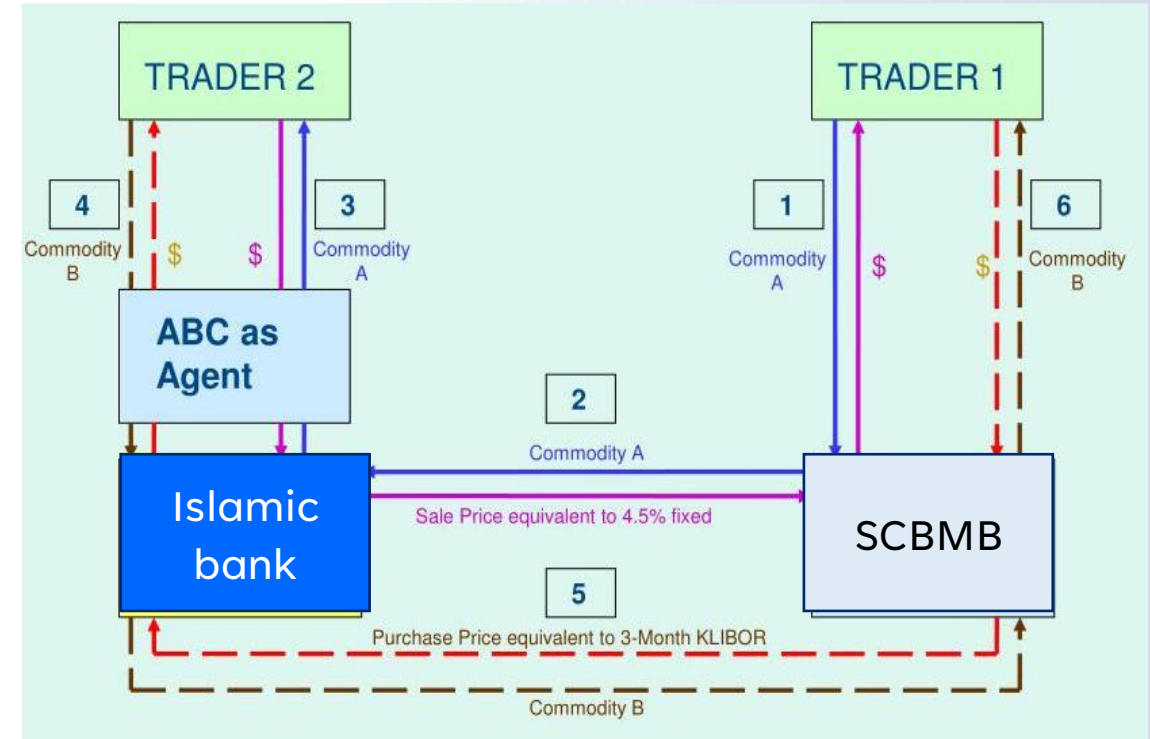
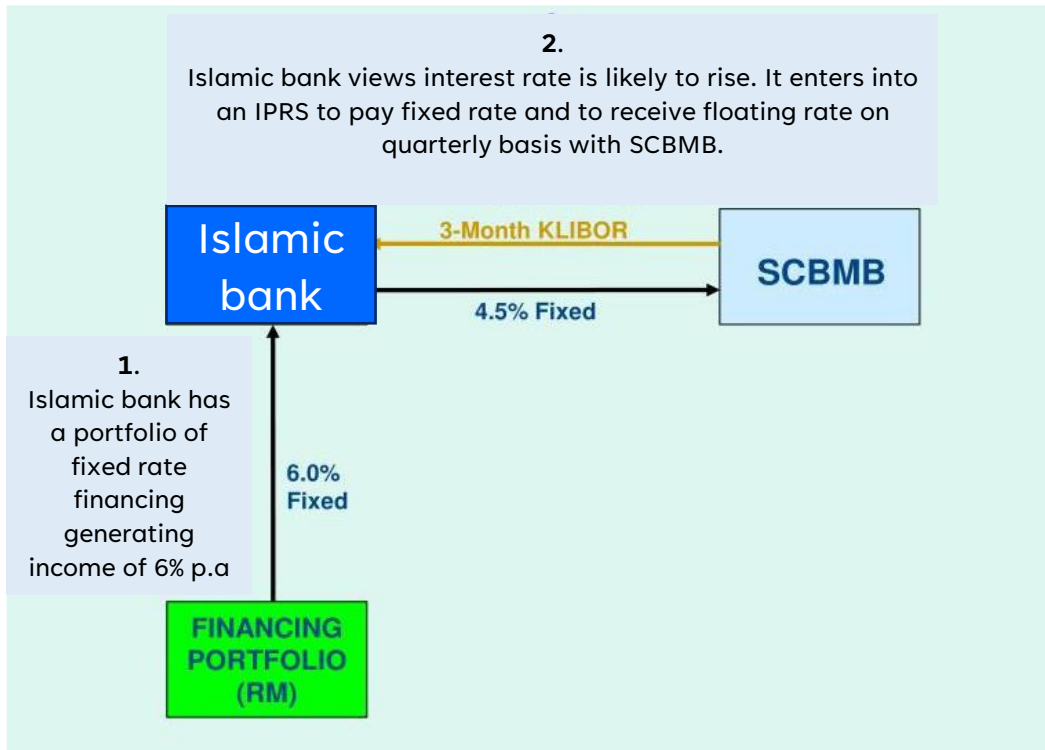
Consider Bank Islam – a hypothetical Islamic bank – which has a portfolio of Islamic financing assets which, on average provides the Bank Islam with a fixed rate of return of 6% per annum.

The CFO of Bank Islam decided that the market interest rate will go through a hiking trend and thus swapping from a fixed payment obligation to a floating rate will provide them with possible risk hedges. They were offered a

- a) Notional Amount to hedge: RM5 billion
- b) Bank Islam receives at every 3 months: 3-Month KLIBOR plus 2% p.a.
- c) Bank Islam pays at every 3 months: Fixed rate of 4.5% p.a

Would Bank Islam be in-the-money or out-of-the-money if the 3-Month KLIBOR rate is at 2.5% p.a?

Profit Rate Swaps



LIQUIDITY RISK:

- Liquidity risk is the potential loss to IFIs arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.
- Liquidity risk is managed through:
 - Maintaining sufficient liquidity surplus and reserves to sustain a sudden liquidity shock;
 - Ensuring cash flows are relatively diversified across all maturities;
 - Ensuring deposit base is diversified and not overly concentrated to a relatively small number of depositors;
 - Maintaining sufficient borrowing capacity in the Interbank market
 - Maintain sufficient highly liquid financial assets;
 - Not over-extending financing activities relative to the deposit base; and
 - Not over-relying on non-Ringgit liabilities to fund Ringgit assets

LIQUIDITY RISK:

Liquidity risk is the potential loss to IBIs arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

Lack of Tradable Instruments

- Most Islamic banks hold tradable securities until maturity.
- This is because there is dearth of tradable securities which are of good credit quality that meets the statutory reserve ratio requirements.
- Such habits have resulted in a weak secondary market for Islamic Sukuk.
- Which affects price discovery and frustrates investors and fund managers.
- This in turn turns off issuers from issuing in the Islamic capital market.

No tradability of Islamic financing instruments

- Most Islamic financing are structured on Murabaha or Tawarruq, which creates a debt receivable.
- This cannot be traded in the secondary market at a discount or premium save an except at par only.
- This again, frustrates financiers from providing long term financing because it is not easy to off load from their books when they need the liquidity.

CREDIT RISK:

- Credit risk is risk of loss arising from default of a counterparty and the negative effect to networth.
- Credit risk is analysed by the respective business of the bank i.e. consumer banking, corporate banking, SME etc.
- Credit risk is also analysed based on sectoral exposure, country exposure, single customer exposure, connected party exposure etc.
- Banks have to identify the Credit Risk Weighted Assets (Credit RWA) to determine the amount of capital to provide to cover against expected losses.
- Expected Loss = Probability of Default (PD) x Loss Given Default x Exposure at Default

Remedies to Credit Risk

1. Proactive strategies

- Check customer credit history
- Review customers credit report
- Create an internal customer credit report

2. Diversify credit risk

- Diversify from single customer
- Diversify from industry concentration
- Review industry risks from time to time

Remedies to Credit Risk

3. Invest in low-risk assets i.e government Sukuk or papers
 - The trade-off is that returns may be low.
4. Maintain sufficient credit risk capital
 - Refer to Basel 3 requirements on capital adequacy
5. Purchase credit risk insurance e.g credit default swaps

MARKET RISK:

Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The risks relate to the current and future volatility of market values of interest rate instruments, foreign exchange exposures, equity products and commodities prices.



OPERATIONAL RISK:

- IBIs are exposed to risks arising from failures in their internal controls involving processes, people and systems. The controls should provide reasonable assurance of the soundness of operations and reliability of reporting.
- IBIs are also exposed to reputational risk arising from failures in governance, Business strategy and process. Negative publicity about the IBI's business practices, particularly relating to Shariah non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity.
- IBIs shall consider the full range of material operational risks affecting their operations, including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. IBIs shall also incorporate possible causes of loss resulting from Shariah non-compliance and the failure in their fiduciary responsibilities.

Quiz

1. What is the role of AAOIFI?

- a) Driving the harmonization of Islamic finance practices primarily through the development and issuance of risk management and governance standards for the global Islamic finance industry.
- b) Driving the harmonization of Islamic finance practices primarily through the development and issuance of capital market and money market standards for the global Islamic finance industry.
- c) Driving the harmonization of Islamic finance practices primarily through the development and issuance of accounting, auditing and Shariah standards for the global Islamic finance industry.
- d) Driving the harmonization of Islamic finance practices primarily through fostering cooperation and capacity building initiatives for the global Islamic finance industry

2. Does Islamic finance recognize “Time Value of Money”? Why/Why not?

- a) No. Money does not have a time-value aside from the value of goods that are being exchanged through the use of money, in accordance with Shariah. Thus, any charge above the contracted price even when there are delays in debt payment, is Riba’.
- b) Yes. Money has an opportunity cost because it can be invested to earn returns. Therefore, charging more because of delays in debt payment is acceptable and fair.
- c) Depends. Time itself has no monetary value but money has a time-value. If Islamic finance uses any other methods other than interest, charging more because of delays in debt payment is justified and not equal to Riba’.

3. Which statement reflects the issue on “Substance Over Form”?

- a) Substance over form happens when the commercial purpose takes precedence over its legal form or contractual structure when determining the accounting records, thus is rejected in Islamic finance.
- b) Substance over form happens when the Shariah compliance is determined based on commercial purpose and economic needs, thus is allowed in Islamic finance.

4. What is the meaning of “Displaced Commercial Risk”?

- a) The risk that an Islamic financial institution charges a fixed profit rate to avoid the floating rate that constitutes a gharar element into a sale contract, thereby foregoing its market competitiveness.
- b) The risk that an Islamic financial institution forgoes part or all of its own profit to provide a competitive return to investment account holders, thereby preventing withdrawals of funds and preserving its market position.
- c) The risk that an Islamic financial institution imposes an additional pricing to embed Shariah risk into its pricing policy, thereby losing its competitive advantage.
- d) The risk that an Islamic financial institution forgoes part or all of its own profit to Zakah.

5. Why are conventional derivatives disallowed from Shariah view?

- a) The countervalues in the two sides of the trade are both non-existent at the time of contract i.e. no good is delivered and no price is paid, though there is a binding contractual agreement between the parties. This triggers the prohibition of gharar.
- b) Interest rate swaps and cross currency swaps are based on the exchange of cashflows from interest rates of the underlying asset, hence triggering the Riba' prohibition.
- c) Derivatives are promises to enter into future transaction which does not justify the imposition of a fee by the promisor as a promise is not a consideration.
- d) All of the above are reasons why Shariah disallows conventional derivatives.

Concluding remarks

1. **Islamic finance has matured significantly** over the past five decades, evolving into a comprehensive financial system offering banking, capital market, investment, treasury, and risk management solutions.
2. **Modern Islamic financial institutions are capable of competing globally**, providing innovative and commercially viable products while adhering to Shariah principles.
3. **Greater standardisation in accounting, disclosure, and risk management** is essential to improve transparency, comparability, and investor confidence across jurisdictions.
4. **Harmonisation with international financial reporting and prudential standards** will enable Islamic financial institutions to be assessed alongside conventional banks using consistent performance and risk metrics.
5. **Standardisation should not come at the expense of Shariah integrity.** Financial reporting must continue to faithfully reflect the underlying Shariah contracts and their economic substance.
6. **Strong governance, effective risk management, and robust accounting practices** remain the foundation for sustaining confidence in the Islamic financial system.

Thank you

Dr. Syed Alwi

syedalwisultan@yahoo.com